No. 18,203

IN THE

United States Court of Appeals

For the Ninth Circuit

ESTATE OF E. W. CHISM, Deceased, Clara Chism, Executrix, and CLARA CHISM,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Petition for Review of the Decision of the Tax Court of the United States

PETITION FOR REHEARING ON BEHALF OF PETITIONERS

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To the Honorable William E. Orr, Frederick G. Hamley, and James R. Browning, Circuit Judges:

Petitioners respectfully petition for a rehearing of the judgment entered by this Court against them on July 30, 1963.

The basis for this petition is the Court's error in assuming, without supporting citations, that the operation of Sections 22(a), I.R.C. 1939, and 61(a)(7), I.R.C. 1954 are not "dependent upon state law". (Op. 5). Upon this faulty first premise, this Court has held that moneys withdrawn under a binding legal obligation to repay them under the law of Nevada could constitute taxable income under federal law. But this is simply not so. Sections 22(a), I.R.C. 1939, and 61(a)(7), I.R.C. 1954, do not reach funds received by a taxpayer under an obligation to repay them. *United States v. Kirby Lumber Co.* (1931), 284 U.S. 1, 52 S.Ct. 4; *Woodsam Associates, Inc. v. Commissioner* (C.A. 2, 1952), 198 F.2d 357, 359; *Commissioner v. Gross* (C.A. 2, 1956), 236 F.2d 612, 615, 618; *Simon v. Commissioner* (C.A. 3, 1960), 285 F.2d 422; Treasury Regulations, § 1.61-12(c). The only inroad that has been made to this rule is in the case of embezzlers: for years they too were sheltered from the incidence of Section 22(a), I.R.C. 1939, because the embezzler "was at all times under an unqualified duty and obligation to repay the money to his employer." *Commissioner v. Wilcox* (1946), 327 U.S. 404, 408, 66 S.Ct. 546, 549. In overruling the *Wilcox* case the opinion of Chief Justice Warren for the Supreme Court carefully excepted from the application of the new rule for embezzlers any moneys received subject to a "*consensual*" obligation to repay. The language of the Court was simple: "*it* (the broad sweep of 'gross income') *excludes loans.*" (Emphasis ours). *James v. United States* (1961), 366 U.S. 213, 219, 81 S.Ct. 1052, 1055.

But how do we determine whether or not funds have been received as a loan? Do we look to federal law, as

this Court has stated (Op. 4-5), or do we look to state law? We look to state law. Thus in *Wilcox, supra*, the Supreme Court found that the embezzler Wilcox had received no taxable income because "(u)nder *Nevada* law, the crime of embezzlement was complete whenever an appropriation was made; the employer was entitled to replevy the money as soon as it was appropriated (citing *Nevada* statutes) or to have it summarily restored by a magistrate (citing *Nevada* statutes). The employer, moreover, at all times held the taxpayer liable to return the full amount. The debtor-creditor relationship was definite and unconditional." (Emphasis added). *Wilcox, supra*, 327 U.S. at 408, 66 S.Ct. at 549.

Sections 22(a) I.R.C. 1939 and 61(a)(7), I.R.C. 1954 establish no federal law of borrowing: an amount is classed as income or loan under these sections depending upon whether or not it is received subject to an obligation under applicable state law to return it. The truth of this principle is readily established. For example, since borrowed funds are not income, the release of the obligation to repay is income, at least to the extent of the increased net worth of the debtor. See Section 61(a)(12), I.R.C. 1954; Treasury Regulations, § 1.61-12. See, also, *Wiese v. Commissioner* (C.A. 8, 1938), 93 F.2d 921, cert. den. 304 U.S. 562, where the stockholder's withdrawals became income only *after* the account receivable on the Company's books was cancelled, *not* when the withdrawals were made.

But what is the nature of the obligation that must be released before the proceeds of the borrowing become taxable income? In *Commissioner v. Jacobson* (1949), 336 U.S. 28, 31, 69 S.Ct. 358, 360, the obligations in question were "leasehold bonds" issued by an individual under Illinois law. As long as these bonds were enforceable against the individual taxpayer, the bond proceeds were not taxable; but as soon as they were surrendered for less than face, the amount of the obligation forgiven became

income. And, see, *Helvering v. American Chicle Co.* (1934), 291 U.S. 426, 54 S.Ct. 460. An exceptional illustration of this principle can be found in *Securities Co. v. United States* (S.D.N.Y. 1948), 85 F. Supp. 532; there the face amount of three promissory notes became taxable income to the maker when the New York statute of limitations ran and the notes became unenforceable under *state* law.

Another example of this rule is found in the area of deductions for losses from bad debts under Sections 23(k), I.R.C. 1939, or 166, I.R.C. 1954. There, as in the cases of Sections 22(a) and 61(a)(7), we find no "express language making its operation dependent upon state law" (Op. 5), yet the Commissioner has frequently been successful in denying a deduction for a bad debt because no valid debt had been created under *state* law. *Julius G. Day* (1940), 42 B.T.A. 109, 111, aff'd per curiam (C.A. 2, 1941) 121 F.2d 856. And, see, *Putnam v. Commissioner* (1956), 352 U.S. 82, 85, 77 S.Ct. 175, 176 (footnote 8), where the Supreme Court looked to the law of Iowa before it determined the nature of an Iowa guarantor's loss under the federal income tax law.

And, finally, we find that this Court itself has held that the concept of "theft" in Section 23(e)(3), I.R.C. 1939 (and presumably also under Section 165(c), I.R.C. 1954) is defined by *state* law although that section "contains no express language making its operation dependent upon state law." *Vincent v. Commissioner* (C.A. 9, 1955), 219 F.2d 228, 230.

Accordingly, the legal premise on which the decision of this Court is based was without foundation. If the Court meant to imply that the Nevada decree was not binding because it established a legal obligation to repay only at the time of death and not at the time of withdrawal (Op. 5), then the injustice done petitioners is just as great:

the Nevada Court could not have held the entry of the probate decree would cause a legal obligation to repay to arise where none had previously existed. The binding effect of the existence of the legal obligation under Nevada law to repay relates as well to the date of withdrawal as it does to the date of the entry of the decree.

To summarize our position on this petition for rehearing, we find the following unfortunate situation to exist:

First, the Tax Court below assumed, correctly as the foregoing authorities show, that taxable income could be imputed to the Chisms only if they were not bound under Nevada law to repay the amounts received. This conclusion is shown by the examination made by the Tax Court of all of the steps that were taken, or not taken, by the parties to establish a valid debtor-creditor relationship under the laws of Nevada, such as the making of book entries, the failure to take a note, and the failure to secure it by collateral (R. 173-174).

Second, the Tax Court below believed itself free to weigh the facts of what the parties had done under Nevada law despite a prior decree of a Nevada probate court on this very question of whether or not a binding legal obligation to repay had been created. The Tax Court felt itself free to make such an inquiry because the probate decree had been entered "in a nonadversary proceeding" (R. 186).

Third, this Court has held, and we believe correctly, that "(t)he Nevada probate court adjudication established that the Chisms had a legal obligation to repay the withdrawals that had been made." (Op. 5). Accordingly, the Tax Court below was in error in not believing itself bound by the prior Nevada court decree on the proper interpretation of Nevada law.

Fourth, but this Court then stated that the Tax Court below was correct in disregarding the Nevada probate

court decree because the existence of a legal obligation under Nevada law to repay is not controlling on whether or not income has been received for federal purposes (Op. 4-5). In other words, the Tax Court below was correct, but for the wrong reason: the question was not whether or not the Chisms had an obligation to repay the money under Nevada law, but whether or not they had such an obligation under federal law.

Rehearing under these circumstances should be a matter of right. Neither party to this case at trial or on appeal argued any such contention; respondent strove mightily to sustain the Tax Court's decision, but on the ground that the Tax Court itself had placed it, namely, that the decree was valueless because it was "nonadversary" (Res. Br. 19-23). That being true, petitioners are faced with the intolerable circumstance of having their appeal denied upon newly conceived grounds upon which they have never had their day in Court. That these newly conceived grounds for denying their appeal are suspect ought to be self-evident since neither experienced government or private counsel nor the learned trial judge below thought to argue or rely on them.

CONCLUSION

A rehearing should be granted.

Respectfully submitted,

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Certificate of Counsel

I, Valentine Brookes, being one of the attorneys for petitioners and the principal author of this petition for rehearing, certify that in my judgment this petition is well founded and is not interposed for delay.

Valentine Brookes